Thought Leadership Discussion

Damages Awards—Income Tax Considerations

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A damages analyst may be retained by legal counsel to any party in a damages claim dispute. Such a dispute typically results from a breach of contract, a tortious action, or some other cause. The damages analyst is typically not a causation expert or a liability expert. Rather, the damages analyst measures the amount of damages suffered by the damaged party related to the allegations made against the damaging party. There are numerous income tax considerations related to damages awards (or negotiated settlements). These income tax considerations include (1) is the receipt of the award/settlement payment taxable income to the damaged party recipient and, if so, is it ordinary income or capital gain and (2) is the payment of the damages award/settlement amount tax deductible to the damaging party payer? The damages analyst—and legal counsel and the disputing parties—should be aware of these tax considerations both (1) in the measurement of the amount of damages suffered by the damaged party and (2) in the analyst's recommendation of the total damages award in the judicial order.

Introduction

Companies often suffer damages due to the wrongful actions of other parties. Those other parties may be employees, customers/clients, competitors, suppliers, the company directors, joint venturers, potential acquirers, bankers, contract counterparties, and even government and regulatory authorities.

In addition, the company owners (e.g., shareholders, limited liability company members, partners) can also suffer damages due to the wrongful actions of other parties. These other parties could include the company itself, the company directors, other shareholders/owners, the company acquirer (actual or attempted), contract counterparties, and others.

For purposes of this discussion, the party suffering the damages (i.e., institutional or individual) is referred to as the damaged party.

For purposes of this discussion, the party responsible for (i.e., the party that causes) the damages is referred to as the damaging party.

When parties (whether companies or company owners) believe they have been damaged, they often pursue a legal claim in order to receive compensation for their damages. That legal claim may be pursued through litigation or through some alternative legal proceeding. For example, many contract-related disputes have to be prosecuted through an arbitration proceeding—according to the terms of the contract.

Regardless of the legal venue, the damaged party typically retains counsel to prosecute the claim. And, the damaging party typically retains counsel to defend against the claim. And, counsel for both parties typically retain (or at least consult with) forensic specialists to assist in the dispute process.

Causation, Liability, and Damages

Of course, there are numerous issues involved in any legal proceeding. With regard to damages claims, there are at least three issues that are relevant to this discussion: (1) causation, (2) liability, and (3) damages measurement.

And, these three issues are only relevant to this discussion if one accepts the following foundational assumption: that the damaged party actually experienced a damages event and suffered measurable damages.

The principal question related to the causation issue is: who or what caused the damages event? The principal question related to the liability issue is: who or what is legally responsible for the damages event? That liability question considers: what party has a duty (contractual or otherwise) to the damaged party? The principal question related to the damages measurement issue is: what is the amount of damages suffered by the damaged party? That damages measurement question considers: what is the amount of cash (or the value of property) needed to restore the damaged party to the economic position that the party enjoyed before the damages event?

The damages analyst often considers what is typically called the "but-for" scenario. That is, what economic (or wealth) position would the damaged party be in "but for" (or without) the impact of the damages event? And, what amount of compensation (whether cash or property) should be paid to the damaged party to restore that party to the economic (or wealth) position it enjoyed before—or but for—the damages event?

Forensic Specialists

As mentioned above, in these damages claim disputes, counsel often retain damages forensic specialists (hereinafter, "damages analysts") to measure the amount of damages experienced by the damaged party. These damages analysts can be forensic accountants, economists, financial analysts, engineers, industry specialists, or other types of professionals. The point is that such damages analysts measure, and provide expert opinions regarding, the amount of damages experienced by the damaged party.

The damages analyst is typically not the same professional who assesses and provides expert opinions with regard to the causation or liability issues in the dispute. That is, it is typically not the responsibility of the damages analyst to assign fault or blame or responsibility to the damaging party.

The damages analyst typically does not conclude that the damaging party is the wrongful party. Rather, the damages analyst quantifies how much the wronged party was damaged—not who is responsible for the damages or who is liable for making the damaged party whole.

Income Taxation Issues

This discussion focuses entirely on damages measurement issues—not on causation or liability issues. In particular, this discussion focuses on one technical, but important, issue related to the measurement of damages. That issue involves the income tax considerations related to the damages measurement.

These income tax considerations relate to the following:

1. The income recognition and the taxation of any payments received by the damaged party
2. The tax deduction and the taxation of any payments made by the damaging party
3. The amount of the judicial award (or the negotiated settlement) required to make the damaged party whole—after any adjustments necessary with regard to the related income tax considerations

This discussion focuses on what the damaged/damaging company, the company owners, legal counsel for these parties, and each party's damages analysts need to know about the income tax considerations related to damages measurements and damages awards (or negotiated settlements).

Types of Damages Claims

Parties to a damages claim-related dispute—and their legal counsel—often categorize damages claims into the following two categories:

1. Breach of contract claims
2. Tort claims

Breach of contract claims, of course, typically generate from a contract. Tort claims typically relate to an alleged breach of one party's duty to another party, where that duty is not documented in a contract.

Breach of contract claims may relate to the damaging party's alleged breach of, for example, a contractor/subcontractor agreement, a client/customer purchase agreement, an employment

agreement, a noncompetition/nonsolicitation agreement, a supplier agreement, a stock purchase or asset purchase acquisition agreement, a joint venture or joint development agreement, a franchise agreement, an intellectual property license, a real estate lease, or any other type of commercial contract.

The contract specifies the respective duties and responsibilities of the counterparties. If one of the counterparties allegedly violates a specified duty or responsibility, then the other counterparty may be damaged as a result of that breach of contract.

Tort claims may relate to the damaging party's alleged breach of a noncontractual duty or a responsibility. For example, a company and its directors have duties to the company's shareholders. A company's controlling shareholder has duties to the company's noncontrolling shareholders. A lender financial institution has duties to its borrowers. Competitor companies have certain duties to each other.

Partners have certain duties to each other (outside of the specific duties documented in the partnership agreement). Public companies have duties to both regulators and to the investor market in general. Trustees have duties to the trust beneficiaries. If one party commits a tortious action and violates its duty to another party, then that secured party may be damaged as a result of the tortious action.

The damages analyst typically considers the above-described categorization of damages claims. This claim categorization—as either a breach of contract or a tort—may affect which of the generally accepted damages measurement methods the analyst applies in the damages measurement analysis.

The damages analyst also considers another categorization regarding damages claims. The analyst considers whether the receipt of the damages award (or negotiated settlement) is a taxable event to the damaged party. That is, the analyst considers if the receipt of the damages award (or settlement) is ordinary income, a capital gain or loss, or a nontaxable event to the damaged party. Analysts may also consider whether or not the payment of the damages award (or settlement) results in an income tax deduction to the damaging party.

And, finally, the analyst may consider these income tax consequences when recommending the amount of a judicial award (or the amount of a negotiated settlement) with regard to the damages claim.

Income Tax Considerations

Even during the normal course of business, a company or a company shareholder may become the recipient—or the payer—of a damages-related judicial judgment or negotiated settlement. That judicial judgment or negotiated settlement may be the result of a commercial litigation, an arbitration, or some type of alternative dispute resolution proceeding.

The income tax considerations of such judgments, awards, or settlements can affect both the recipient and the payer. And, the income tax considerations related to the damages measurement may affect the amount of the judgment or settlement that would be required to make the damaged party economically "whole."

These income tax issues affect both the recipient and the payer of the damages judgment, award, or settlement. The specific terms of the judgment or the settlement typically affect whether the payment is:

1. tax deductible or not tax deductible,
2. taxable income or not taxable income, and
3. if taxable, whether the income is ordinary income or capital gain.

As with most income taxation issues, the taxpayer has the burden of proof regarding both the tax treatment and the income characterization (ordinary or capital gain) of the judgment or settlement payment.

These issues are typically determined by reference to the particular language included in the underlying litigation documents. Such documents include:

1. the pleadings,
2. the court's order or the arbitration award, and/or
3. the settlement agreement.

Taxpayers (both parties to the dispute) and their legal counsel should consider these taxation issues when drafting such litigation-related documents.

The income tax treatment of the payment is not influenced by whether the award is the result of:

1. a court or an arbitration order or
2. a settlement agreement between the parties.

However, generally, taxation issues are easier to deal with in the case of a settlement agreement that is drafted by counsel to the parties. This is simply because the court or the arbitrator may be less sensitive to the particular wording needed in the final litigation documents that may influence the desired income tax treatment.

Generally, taxation issues are harder to deal with in regard to a court's order or an arbitrator's award. This is because the judge or the arbitrator is typically more concerned with legal issues than with taxation issues.

The Origin of the Damages Claim

The origin of the damages claim may directly influence the tax treatment of the judicial award or the settlement payment. Many courts apply the so-called origin-of-the-claim test with regard to this taxation issue. That is, the courts typically consider the question: "in lieu of what was the damages payment award?"

This consideration affects the tax characterization of the damages payment. This test has been applied since at least the *Raytheon Production Corp* decision.[1]

For the recipient of a settlement payment, the origin-of-the-claim test may determine whether the payment receipt is taxable or not taxable. If the receipt of the settlement payment is taxable, then this test may determine if the income should be characterized as ordinary income or as capital gain. Typically, damages awards received related to either a judgment or a settlement are taxable income to the recipient.

However, the receipt of certain damages payments is not considered to be taxable income. Examples of such nontaxable payments include gifts or inheritances, payments as compensation for a personal physical injury, certain disaster relief payments, amounts for which the taxpayer did not previously receive a tax benefit, cost reimbursements, the recovery of capital, or a property or business acquisition purchase price adjustment.

Damages awards are typically taxable as ordinary income if the payment relates to a claim of lost profits. However, such an award may be characterized as a capital gain (to the extent that the amount of damages exceeds the property's tax basis) if the damages claim relates to the damage of a capital asset.

For the payer of the damages award, the origin-of-the-claim test will typically determine whether the payment is tax deductible or not tax deductible. In addition, the test will typically determine whether a tax deductible payment will be currently deductible or whether it has to be capitalized.

For example, a damages payment related to a personal transaction will be considered a nondeductible personal expense. In contrast, a damages payment related to a business activity may be deductible under Internal Revenue Code Section 162. And, business-related damages payments related to interest, taxes, or certain losses will be deductible under Section 163, Section 164, or Section 165, respectively.

Certain damages payments are not tax deductible. Other damages payments would have to be capitalized. For example, damages payments would have to be capitalized when the payer receives an intangible asset or an intellectual property license, say as part of a negotiated settlement, in exchange for the payment.

Again, the burden of proof is on the taxpayer to establish the appropriate income tax treatment related to the receipt or the payment of the damages judgment or settlement.

The types of documents that the Internal Revenue Service ("Service") will consider with regard to the tax treatment issue include the following: the legal filings, the terms of a settlement agreement, any correspondence between the parties to the dispute, any internal memos of the parties, party press releases, company annual reports, and news-related publications.

As a general guideline, the Service considers the initial complaint (or the equivalent legal document) to be the most persuasive evidence. This general guidance is presented in Revenue Ruling 85-98.

How to Allocate the Damages Payment

Sometimes the judicial award or the negotiated settlement payment can cover more than one claim. In that case, the parties to the dispute may have to allocate the payment for federal income tax purposes. Such an allocation is necessary when part of the payment represents a taxable event and another part of the payment relates to a nontaxable event.

In addition, such an allocation may be necessary when there are either multiple plaintiffs (claimants) or multiple defendants (respondents).

Some of the factors that the parties to the dispute should consider in that allocation process include the following:

1. Who made and who received the payment
2. Who was economically harmed or economically benefited by the damages event
3. Which party were the allegations asserted against
4. Which party controlled the litigation

5. Whether the dispute-related costs or receipts were required to be shared contractually
6. Whether there was joint and several liability among the parties related to the damages claims

The court's order or the settlement document may provide for an allocation in the text. If an allocation is already specified in the judicial judgment, then the Service and the taxpayers are typically bound by that allocation. In addition, the Service will typically accept an allocation that is specified in a negotiated settlement agreement.

However, the Service may challenge a settlement-related allocation if the Service concludes that the taxpayer had another (nontaxation) reason for the agreed-upon allocation. As with most issues, the taxpayer has the burden of proof with regard to defending the claimed award allocation before the Service.

Statutory Tax Deduction Disallowance

The Internal Revenue Code specifically disallows tax deductions related to certain payments or liabilities incurred with respect to a court's judgment or a negotiated settlement.

As amended by the Tax Cuts and Jobs Act ("TCJA"), Section 162(f) disallows a tax deduction (under any provision of Chapter 1) related to amounts paid or incurred:

1. by a lawsuit, an agreement, or otherwise;
2. to, or at the direction of, a government or governmental entity; and
3. in relation to a violation of law—or an investigation or inquiry into a potential violation of law.

This tax deduction disallowance does not apply for payments for:

1. the restitution (including the remediation of property),
2. taxes due, and
3. amounts paid pursuant to a court order when no government or governmental agency is a party to the dispute.

The Treasury Regulations also indicate that this tax deduction disallowance does not apply to:

1. disputes in which the government enforces its rights as a private party—for example, in a breach of contract dispute—or
2. routine audits or inspections not related to a possible wrongdoing.

The restitution exception to the tax deduction disallowance only applies if the court order or the settlement agreement identifies the damages payment (1) as a restitution or remediation payment or (2) as a payment to come into compliance with the law (i.e., collectively referred to as the identification requirement).

In addition, the taxpayer must establish that the damages payment was made:

1. for restitution or remediation or
2. to come into compliance with the law (i.e., collectively referred to as the establishment requirement).

The taxpayer may satisfy the identification requirement if the court order or the settlement agreement specifically states that the payment (1) constitutes restitution or remediation or (2) is for coming into compliance with the law—or uses some form of similar language. The taxpayer may satisfy the establishment requirement by providing the Service with documentation evidence of the elements of establishment.

The TCJA also added Section 162(q) related to tax deductions with regard to damages payments. Section 162(q) disallows an income tax deduction (under any provision of Chapter 1) for a settlement or other payment (1) related to sexual harassment or abuse and (2) related to the corresponding attorneys' fees—if there is a nondisclosure agreement.

However, this Section 162(q) tax deduction disallowance does not apply to the attorneys' fees incurred by the sexual harassment/abuse victim.

There are various other Internal Revenue Code Sections that disallow tax deductions related to certain types of damages payments. For example, Section 162(i) disallows a tax deduction related to illegal bribes and kickbacks. And, Section 162(q) disallows a tax deduction related to the treble damages imposed for antitrust violations.

Adjusting the Damages Measurement for Income Tax Consequences

The damages analyst often has to adjust a damages measurement amount for the income

tax consequences of the damages award receipt. Without such an adjustment, the damaged party will not be "made whole" by the receipt of the damages award.

The damaged party would not be "made whole" by the damages award receipt if the damages award or settlement payment was recognized as taxable income to the damaged party recipient.

In addition, without such a tax-related adjustment, the damaging party may benefit from the income tax deduction associated with certain damages-related payments.

For example, let's assume that Alpha Company is the damaged party and Omega Company is the damaging party. In this hypothetical example, Omega wrongfully caused Alpha to suffer $12 million of damages related to lost profits. Alpha brings a damages claim against Omega. The claim is litigated.

The finder of fact finds Omega to be liable and orders that Omega pay a $12 million lost profits damages award to Alpha. In compliance with the finder of fact's judgment, Omega pays the $12 million damages amount to Alpha.

Let's further assume that the lost-profits-related damages award is recognized as taxable income to Alpha. To simplify the calculation, let's assume a 25 percent effective combined federal and state income tax rate for Alpha.

Alpha suffered $12 million lost profits in damages. If Alpha receives a $12 million damages award, Alpha will pay $3 million in income taxes. After tax, Alpha will be left with only $9 million. Accordingly, Alpha will not be "made whole" by the $12 million damages award.

If Alpha recognizes taxable income related to the $12 million damages award receipt, it is likely that Omega will qualify for a tax deduction related to the payment. That is, after taxes, Omega will end up with $9 million less cash (even though Omega paid a $12 million payment to Alpha).

So, while Omega was determined to be liable for the $12 million of damages to Alpha, Omega will only suffer a $9 million negative economic impact. And, although Alpha was determined to have suffered $12 million in damages, Alpha will only recover $9 million in economic benefit.

There are two different tax-related adjustment procedures that the damages analyst may apply to account for these income tax considerations.

The first tax adjustment procedure is to calculate the present value the pretax lost profits suffered by the damaged party using an after-tax present value discount rate. In theory, this tax adjustment procedure increases the amount of the lost profits damages by the amount of the income tax impact on the lost profits.

This procedure may be the less frequently applied of the two tax-related adjustment procedures. This tax adjustment procedure really only works in a lost profits damages measurement calculation. That is, this adjustment procedure is generally not applicable to many other damages measurement methods—such as the cost to cure damages measurement method, for example.

And, the apparent mismatch in the damages measurement (i.e., pretax lost profits and an after-tax present value discount rate) may be somewhat difficult to explain to the finder of fact in the dispute.

The second tax-related adjustment procedure is more frequently applied by damages analysts. It is generally applicable to all damages measurement methods. And, this adjustment procedure is fairly easy to explain to a finder of fact—and to other parties involved in the dispute. In this second adjustment procedure, the damages analyst simply identifies and quantifies the two components of the recommended judicial award.

Let's return to the Alpha and Omega example. To apply this second tax-related adjustment procedure, the damages analyst will quantify both:

1. the amount of the lost profits damages that Alpha suffered and
2. the amount of the income tax liability that Alpha will incur with regard to the receipt of the damages award payment.

The sum of these two components would represent the amount of the total judicial award that the analyst would recommend to the finder of fact.

So, in our example, the analyst would conclude the recommendation with regard to the total damages payment as presented in Exhibit 1.

That is, the analyst would recommend that the finder of fact award (or that the parties agree to in a negotiated settlement) a $16 million total payment to Alpha.

Based on the receipt of the $16 million total payment, Alpha will incur a $4 million ($16 million × 25 percent) income tax liability. After that $4 million income tax liability is expensed (i.e., paid to the federal and state taxing authorities), Alpha will be left with $12 million. That is, as a result of the $16 million total award payment, Alpha will be made whole with regard to the $12 million of lost profits related to the damages event.

As a result of the damages event caused by Omega, Alpha's economic position decreased by

Exhibit 1
The Total Damages Award Calculation With an Adjustment for Income Taxes

Measurement of the Amount of Damages Suffered by Alpha Company	$12 million
Divided by: 1–25% Effective Income Tax Rate	75%
Equals: Total Damages Payment (the recommended total award amount) Required to Make Alpha Company Whole after the Damages Event	$16 million

$12 million. Based on the $16 million total award payment from Omega, Alpha's economic position (after income taxes) would increase by $12 million. Accordingly, the $16 million (pretax) payment is required to make Alpha whole after experiencing the impact of the damages event.

Again, assuming that the type of damages in this illustrative example relates to a taxable event, Omega will typically benefit from a $16 million income tax deduction if Alpha recognizes $16 million of taxable income.

In other words, after the income tax impact (assuming the illustrative 25 percent income tax rate), the $16 million payment will decrease Omega's economic position to $12 million.

This second tax adjustment procedure is typically applied by damages analysts because it separately reveals the impact of income taxes on the recommended amount of the damages award.

This second tax adjustment procedure clearly identifies that the recommended damages award should include two components:

1. The amount of the damages suffered by the damaged party
2. The income tax impact on the damaged party of the receipt of the damages award or the settlement payment

Summary and Conclusion

Companies may suffer damages due to the wrongful actions of various other parties. These damages may be caused by a breach of contract, a tortious act, or some other reason. And, the wrongful party may be a competitor, customer, employee, shareholder, banker, supplier, government agency, or other party.

When a company is damaged, it typically retains legal counsel to prosecute the legal claim. Counsel typically retain a forensic accountant, economist, or some other type of damages analyst to measure the amount of damages suffered by the damaged party.

In the development of the damages analysis, that damages analyst—and all of the parties to the dispute—should consider all of the income tax consequences to the parties.

There are income tax consequences related to the receipt or the payment of amounts relates to a judicial order or a negotiated settlement.

The taxable income recognition, the tax deduction, and the income character (that is, ordinary income versus capital gain) of the payments typically depend on:

1. the type of the damages claim and
2. the identity of the damaged party and the damaging party.

These issues are typically reflected in the legal documents related to the dispute. In particular, certain income tax deductions disallowances may apply with regard to the damages award payments.

All parties to a damages dispute should consider the income tax consequences of any damages payments when negotiating a dispute settlement agreement or when considering a court order or arbitrator's award.

In addition to the damaged party and the damaging party, legal counsel, damages analysts, and other professionals involved in the dispute should consider these taxation issues.

With some planning and some cooperation among the parties, some unfavorable tax consequences may be avoided.

In any event, all income tax consequences should be accounted for in the damages measurement analyses, any damages award recommendations or deliberations, the dispute settlement negotiations, and the litigation prosecution and defense.

Note:

1. Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944).

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